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OFFICE OF
NATIONAL ESTIMATES

MEMORANDUM

This Year's Oil Crisis: The Issue of Participation

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CENTRAL INTELLIGENCE AGENCY

OFFICE OF NATIONAL ESTIMATES

24 March 1972

MEMORANDUM

SUBJECT: This Year's Oil Crisis: The Issue of Participation*

SUMMARY

The major breakthrough in the current round of negotiations between the Organization of Petroleum Exporting Countries (OPEC) and the oil companies holding concessions for the production of crude oil has occurred. Aramco has agreed in principle, under an ultimatum from King Faisal, that Saudi Arabia may acquire a 20 percent share of the assets and operations of the company. The Saudis were negotiating on behalf of five Persian Gulf OPEC members -- Iran, Iraq, Kuwait, Abu Dhabi, and Qatar -- and several of these members have since made similar agreements.

Long, arduous negotiations over the timing, amount and method of compensation, future financing, and disposition of the several governments' share of oil production are in prospect. Much is at stake in terms of company investment and profits, country pride, additional government income, and in the long run prices to consumers of petroleum products. There will be crises in settling details, perhaps even temporary interruptions of oil flow in some instances.

This memorandum discusses the reasons for the present company-country confrontation, the problems involved in participation, and some consequences for the international oil industry and the governments concerned of the agreement on participation.

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* *This memorandum was prepared by the Office of National Estimates and discussed with other components of the CIA, who are in general agreement with its judgment.*

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Background

1. The demand of the Organization of Petroleum Exporting Countries (OPEC)[1/] for "participation" in the operations of the international oil companies is another step in the restructuring of the international oil business.[2/] This demand applies to wholly-owned concessions of the classic type and not to the more recent agreements which are essentially joint ventures between a country and an oil company. This restructuring process away from such concessions toward new patterns as yet not clearly defined has been in process for some time. The most important aspect of the current negotiations is the manner in which this restructuring proceeds in the several OPEC countries.

2. After years of discussions among the OPEC countries about ways of achieving greater control over the rewards from exploiting their oil resources, OPEC members announced publicly

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1/ *The OPEC countries are: Abu Dhabi, Iraq, Iran, Kuwait, Libya, Saudi Arabia, Qatar, Algeria, Nigeria, Venezuela, and Indonesia. Only the Persian Gulf countries are presently negotiating.*

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2/ [redacted] *November 1970,* [redacted] *pointed out that the producing countries would increasingly press for changes in their relationships with the oil companies, which would give the countries a greater control over the activities of the companies.* 25X1

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that they would hold discussions with the oil companies in early 1972 on the subject of participation. Rapid expansion of petroleum consumption in the developed world during the 1960s had speeded up change in the bargaining position of the countries from one of disadvantage to one of superior strength. OPEC members made clear that they intended to reap the full measure of this advantage.

3. OPEC countries have been well aware for years that rivalry among their members for greater oil output as a means of acquiring more revenue has worked to their own detriment. Producing a fungible commodity whose supply was large in relation to demand, the countries found themselves at a disadvantage. In 1960, shortly after it was formed, OPEC succeeded in placing a floor under the price of crude oil on which payments to the countries were based. During the 1960s, the countries achieved several small increases in per barrel earnings. Since 1970 the oil industry has been subjected to even stronger OPEC pressure. Acting in concert, they forced the companies into no less than seven agreements, each of which increased the cost of

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crude oil substantially.1/ In 1971 alone, the average per barrel cost to the companies increased about 20 percent.

*The Countries' Attitudes*2/

4. The present OPEC demand is for a 20 percent interest in the ownership and operations of the companies producing oil from concessions in each of the OPEC countries. OPEC spokesmen have asserted that the organization's eventual goal is at least a 51 percent interest. It would not extend to any of the companies' operations abroad. Under the arrangement envisaged, for example, Saudi Arabia is to acquire a one-fifth interest in Aramco, but not in Aramco's parent companies (Standard of California, Texaco, Standard of New Jersey, and Mobil), or Libya a one-fifth interest in ESSO Libya, a wholly-owned subsidiary of Jersey Standard.

1/ *The agreements were: 1970, Libya (September), Persian Gulf (November), Venezuela (December); 1971, Teheran (February), Tripoli (April), Mediterranean Pipeline Oil (June); 1972, Geneva (January). Not all companies were involved in all of these, although the major internationals were in most. The price increases under the terms of these agreements were not all cumulative, in some cases they came about as a result of a previous agreement.*

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5. The oil producing countries look on participation as a step in achieving control over their principal -- and in some instances sole -- natural resource. The countries also wish to gain more revenue, and participation is one way to do this. In addition, the several governments are in varying degrees responding to domestic pressures to eliminate foreign "exploiters". Although there is no strong demand for participation as such, it can and will be advertised as, in effect, phased nationalization.

6. The present phase of participation will not directly enlarge the possibilities for broadening the experience of nationals in the oil industry. In fact, the great majority of oil jobs in most of these countries already are carried out by locals. Only the most sophisticated positions are held by foreign nationals and the oil countries are gaining more and more native talent in these fields every year. Of course, conditions vary from country to country, with Libya and some of the smaller Persian Gulf sheikhdoms still short of sufficient talent while Iraq, Iran, and Saudi Arabia are close to self-sufficiency in production personnel. The field where virtually all producing countries lack talent is in the world market aspects of oil operations -- planning, financing, transporting, and marketing. Participation

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per se will not provide expertise in these areas, since the producing companies involved do not market abroad. However, it will provide low-cost oil for the several national oil companies to use as they move into marketing in the years ahead. The low cost will provide a cushion against expensive mistakes as they seek experience in this more complex aspect of the business.

7. Existing relations with the oil companies have already enabled the producing countries to learn "secrets" of the business and to have some say in company decisions. For the present, the countries are wary of the responsibilities of day-to-day management. The countries are aware that the process of gaining control over the disposition of their great natural resource will be neither quick nor simple. From the experience gained through their government-owned oil companies, the countries know that the sheer size of the industry and the complex distributing, refining, and marketing system make rapid change all but impossible and, indeed, potentially dangerous to themselves. Abrupt moves carry a risk of disrupting production -- and hence revenues -- on which OPEC countries depend for most of their governmental income. In these circumstances, a nibbling approach through participation commends itself to them.

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8. Even within OPEC, some countries diverge from the majority view on participation due to differing circumstances. Algeria has already taken over a majority interest in the oil producing companies operating there and the state now controls 77 percent of oil production. It has been able to achieve this position in part because of the mutual interest of Paris and Algiers in keeping bilateral trade flowing. Libya -- unique among oil producing states in having financial reserves adequate for at least two years of government spending at the current rate -- has the strongest ideological urge for nationalization. Iran is at the other end of the spectrum; the terms under which the oil consortium operates end in 1979, when new terms must be arranged, and in any case, the Shah's chief concern is money, not the legalities of ownership and control.

The Companies' View

9. While they fully recognize that the international oil scene has changed markedly, the companies have been inclined to stall as long as possible any change in the basic concession structure. They regard the participation demand as a violation of their concession agreements and especially of the five-year revenue agreement reached with the producing countries at Teheran

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in February 1971. Moreover, this demand has come on the heels of the numerous increases in the payments to host governments.

10. The companies are also distressed by OPEC's argument that a "doctrine of changing circumstances" prevails -- the companies fear that any time the countries feel that they want a better deal they have the right to force one, despite previous contractual agreements. Acquiescence in this view would open a Pandora's box for further and more extreme demands. The companies believe that they must have stability if they are to run their day-to-day business, plan for the future, obtain financing for expansion, and that continual demands on the part of the countries tend to create conditions unfavorable to orderly business procedure.

11. Perhaps more basically, the large international companies (those with multiple sources of crude oil and widespread markets) consider that participation will complicate carrying on their business. In the past, each major company has been able to view its operations around the world as a whole and to vary the geographical origin of its crude supplied to markets according to such business considerations as cost, tanker availability, and the qualities of the oil itself (sulphur content, and so on). The companies fear that non-business considerations on the part

of participating countries would affect company decisions on such matters as levels of production and investment in new equipment and installations -- in short, that host country parochialism would adversely affect their business flexibility.

The Current Discussions

12. For some time, the Shah of Iran has taken the lead among the Persian Gulf OPEC members in pressing for increased oil revenues. Since he was uninterested in the forthcoming OPEC participation demand, he initiated conversations last November with the companies wherein he spelled out his ideas concerning a new relationship with the Consortium* following the expiration of its concession in 1979. An imaginative individual, the Shah envisions great expansion for his National Iranian Oil Company (NIOC). Under his suggestions for a new agreement with the Consortium, NIOC would be entitled to a substantial amount of Consortium oil at a "premium" (i.e., bargain) price, a

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* *The Consortium, formally known as Iranian Oil Participants, Ltd., consists of British Petroleum 40 percent, Royal Dutch Shell 14 percent, Cie. Francaise de Petroles 6 percent, Jersey Standard, Mobil, Gulf, Texaco, California Standard, 7 percent each. The remaining 5 percent is held by Atlantic Richfield, Aminol, Signal, Getty, Continental, Ohio Standard, and Tidewater Oil Companies.*

new export refinery and a petrochemical plant in Iran, the latter as a joint venture with NIOC, and a partnership in "downstream" (i.e., once oil has left the producing field) operations outside Iran with individual members of the Consortium.

13. The companies, for their part, have offered to increase production capacity to 8 million barrels per day (from a present 5 million) by the mid-1970s, to increase their exploration effort, and to relinquish large concession areas for a joint venture operation with the National Oil Company. The "premium" price of oil to NIOC could not be at cost, according to the companies, as this would be "participation without investment". They agreed to consider but not to commit themselves to downstream operations outside Iran in conjunction with NIOC. They would study the economic feasibility of the proposed refinery and petrochemical plant. The conversations ended with the Shah remarking that he cannot remain aloof from the participation demand indefinitely. The companies are still considering the Shah's proposals and no further meetings are scheduled until the latter part of March.

14. Though the companies were originally attracted by a possible alternative in Iran to participation, they now feel that they must tread carefully lest they end up agreeing to the Shah's proposals as well as to participation thereby creating precedents to be extended to their operations in other producing countries. In particular, the "premium" price of oil to NIOC and the downstream venture request pose problems. However, the climate of the discussions has been cordial.

15. In early March the discussions between Aramco (whose four parent companies -- Jersey Standard, Mobil, Standard of California, and Texaco -- each have a 7 percent share of the Iranian Oil Consortium) and Saudi Arabia produced a sudden agreement. Aramco accepted the principle of 20 percent Saudi participation in the company, after an ultimatum by King Faisal so to agree by March 11 or face unilateral Saudi legislation. The oil company has reserved its position on the timing, amount of compensation and the methods of paying it, the disposition of the Saudi share of Aramco oil production, future financing requirements, and so on. As noted below, these are knotty issues which could take a long time to settle.

16. Nonetheless, this is a historic breakthrough; Aramco and the Saudis have led the field in the Near East as they did with the 50-50 profit-sharing arrangement 20 years ago. Faisal and the Saudis apparently felt themselves to be under considerable pressure from Arab opinion not to seem to be acting as a compliant tool of the US. The King also seems to have been concerned that Saudi Arabia get an arrangement satisfactory to it and not be forced to follow a pattern set by another -- perhaps more radical country. The other Persian Gulf OPEC members have agreed to accept the Saudi lead and support each other in seeking to settle the participation issue on terms broadly similar to Saudi Arabia's.

Consequences of Agreement on Participation

17. We cannot at this point forecast how the details of financing, compensation, sale of participant oil and the like will be worked out. There are, however, some consequences which are foreseeable.

A. For Company-Country Relations

18. The process of working out the details of participation will require the complete re-writing of existing company-country concession agreements. Concessions will, in effect, become joint

ventures of the sort which some oil companies have already made, e.g., Pan American in Egypt, but which the majors had not entered into until fairly recently, e.g., British Petroleum and Shell in Nigeria. But the process of reaching agreement on implementing participation will entail many crises; disputes over terms will probably bring negotiations to the edge of breakdown. In fact, we would not be surprised if temporary interruptions in oil production occurred; one or another producing country might find it useful to remind the oil industry by such a tactic just where the control of resources lies.

19. The issues of valuation, the country's proper shares of investment financing and current income, and mechanisms for selling the governments' share of the oil are likely to be the most complex ones. In some cases, changes in the corporate structure of producing oil companies will be required. The setting of a price on the participating interest to be acquired by the countries promises to be highly contentious. [redacted] 25X1 25X1 indicated the price should be based on "book value", that is original investment less the depreciation which has been written off by the companies for tax purposes. This figure would be far

below the value that the companies are likely to contend is equitable; they will wish to take into account the replacement cost of plant, the value of reserves and the earnings which would accrue to the companies if the concessions ran their full term, or perhaps for some five to ten years more.

20. Reaching agreement on expenditure for financing exploration and expansion of producing facilities could be very touchy. Even though the OPEC countries are getting vastly increased (and increasing) revenue from last year's Teheran agreements, most of them are likely to put a high priority on other costly expenditures for arms and various government services. Four of the Persian Gulf states, Abu Dhabi, Kuwait, Qatar, and Saudi Arabia, appear to have sufficient reserves to make some down payment on their share of investment. Iraq and Iran, if they are to participate, would almost certainly seek to pay whatever value is agreed for their 20 percent share and for their portion of investment by financing out of future earnings.

21. Another problem requiring a Solomon for solution is how a country's share of the oil would be marketed. Initially, most of it would probably be sold to the parent companies, as

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the countries are not likely to desire or be able immediately to market much of it on their own. Intricate accounting and conceptual problems would again arise in determining the price to the parent companies for this oil, since the price on which the companies pay their royalty and taxes to the host governments is an inflated and theoretical one (posted price), not the lower going market price. There has been some talk of a "half-way" price; one half-way between the "posted" (theoretical royalty-tax price) and tax paid cost. The companies object to this because such a price could be too close to -- or even above -- market prices to provide a profit for the companies. All these issues -- and subsidiary ones as well -- will be worked out somehow, probably with neither party gaining a complete victory for its point of view.

B. For Certain OPEC Countries

22. The impact on the oil producing countries will be varied. King Faisal will be able to point out that Saudi Arabia once again has led the way to a new and basic change in the oil business, a victory for the producing countries. His position in the Arab world will be strengthened, especially

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vis-a-vis the radical Arab states. Within Saudi Arabia Faisal's prestige has been increased. Meanwhile, Saudi Arabia's oil production and income will continue to rise.

23. The implementation of participation may be most difficult in Iraq. Not only is Iraq's financial position worse than other Persian Gulf OPEC countries, but a host of unsettled issues between Iraq and the Iraq Petroleum Company (IPC) have been outstanding for years. The OPEC resolution passed in Beirut on March 11 recognizes Iraq's peculiar position and pledges the support of the other members.

24. The Shah may be able to use participation to achieve his objective of a large volume of oil at cost for use by NIOC. Even if he could obtain a share of the Consortium's production by payment out of future earnings, he might find it unprofitable to do so if he intends to terminate the concession in 1979. On the other hand, he might find a formula to achieve his objectives through participation which would encompass extension of the concession (as he has promised if his demands are satisfied) and provision of cost oil to NIOC. The possibilities are numerous, including substitution by Iran of participation in downstream operations of the Consortium members in lieu of

participation in the producing operations in Iran. Consequently, the resolution of the Iranian demands are likely to be not only difficult, but delayed, awaiting what transpires in Saudi Arabia and Iraq.

25. Despite its public espousal of drastic moves against the oil industry, the maverick Libyan regime may go along with any OPEC Persian Gulf settlement. Already somewhat shaken by its frustration in selling the nationalized British Petroleum oil, the regime may not push for the immediate 51 percent participation it has publicly demanded in the foreign-owned oil concessions. Libya's advantageous position as a short-haul source of oil has been eroded over the past 18 months; shipments from the Persian Gulf to Europe have increased at Libya's expense. Consequently, Libya will be in a relatively weak bargaining position in the coming round of negotiations on participation.

26. The OPEC victory in the Persian Gulf would appear to having varying effects in the non-Arab oil producing countries; each of these -- Venezuela, Nigeria, and Indonesia -- is subject to special conditions. Venezuela has legislated what it considers a satisfactory relationship with the oil companies. The concessions run out in about 10 years and there appears to be little

financial advantage to be gained by imposing the OPEC breakthrough. Participation -- at least at 20 percent -- will be extended to the older concessions in Nigeria, which account for 90 percent of oil production. Cal-Tex dominates the Indonesian oil industry, producing about 80 percent of the country's oil. Its concessions will expire within a relatively short time; all other concessions already provide for participation by the state-owned oil company. Also, oil company payments there are based on market prices, not the posted price.

27. While the oil producing countries have wielded considerable influence over the oil companies operating in them, success in achieving participation will substantially increase their influence in the oil business. Despite their holding a minority interest in the producing companies, the countries are likely to demand -- and get -- special treatment in certain instances. Participation also will facilitate producing countries' efforts to get into the downstream side of the oil business.

C. Longer Term Prospects

28. Agreement on 20 percent country participation is but a step in the ongoing restructuring of the international oil business.

The OPEC countries accepting 20 percent will surely press for a larger percentage; the abrupt company acquiescence to the participation demand will probably spur additional demands within a relatively short time. The oil companies will try, in the course of the present negotiations, to get the countries to agree to a period of consolidation during which further demands will be put in abeyance. The countries, falling back on their "doctrine of changing circumstances" are almost certain -- irrespective of agreements -- to press for additional increments of participation when they judge prospects for success to be favorable. Concessions and contractual agreements will thus lose their former value.

29. Despite their many differences, we believe it more than likely that the members of OPEC will continue to cooperate in matters of oil industry policy. They know from direct experience
cooperative
how advantageous to their own interests such ~~cooperation~~ action
to
can be. In addition they are quite aware of the dangers ~~of~~ their
interests
own advantage which lie in competition with one another for expanding markets. Indeed the OPEC Secretariat has recently advised its members of the importance of retaining the companies' participation in marketing. The recent proposal of OPEC to establish a fund of $150-200 million to support any country in

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a confrontation with the oil companies is an earnest of their commitment to concerted action.

30. Income from US oil ventures abroad presently adds about $2 billion annually to the US balance of payments, about as much as that from all other US investment abroad combined. Under certain assumptions 20 percent participation could cut that inflow by a like percentage. In fact, such a direct ratio is not likely to obtain; leaving aside investment financing, company returns are not likely to decline by 20 percent. Nonetheless, the balance of payments will suffer to some degree unless the cost of participation can be passed on to consumers in higher prices or growth in production brings higher net income to the US oil firms.

31. If company profits are seriously affected, however, can consumer prices be raised sufficiently over the next few years to compensate? The companies' answer to this issue requires a careful balancing of their needs against the likely consequences of increased prices in the consuming countries. Escalation clauses in the 1971 OPEC-oil company agreements will raise country revenues by some 10-12 percent by 1975 and will probably result in higher prices to consumers as well. The reaction of consumers and their governments to still higher prices would certainly become increasingly

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strident if prices rise sharply in a relatively short time span. More important from the companies' viewpoint is the degree to which rising oil prices over the longer term would cause consumers to explore different sources of energy or would increase the likelihood of active government interference in the oil industry.

32. Indeed the companies could find themselves trapped between the opposing interests of producing and consuming governments. So long as consumers accept higher oil prices, the producing countries are likely to be encouraged to press for more participation or higher revenues per barrel or both. If consumers rebel at higher prices, they are likely to call for profit-limiting interference by their own governments. A critical and important factor in determining whether such interference comes about will be the pace of OPEC's future demands for more income. But because both producing and consuming countries find the oil companies essential middlemen in the distribution and marketing process, we do not expect the governments of the major producing or consuming countries to undertake direct bilateral negotiations with a view to eliminating the oil companies' role in the next few years.

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TABLE

WORLD CRUDE OIL PRODUCTION, 1971
(Barrels Per Day)

	Thousands Barrels Per Day
EASTERN HEMISPHERE	
Middle East	
Abu Dhabi a/	934
Iran a/	4,535
Iraq a/	1,712
Kuwait a/	2,925
Oman	289
Qatar a/	429
Saudi Arabia a/	4,497
Other Middle East	1,060
TOTAL	16,383
Africa	
Libya a/	2,761
Algeria a/	720
Egypt	294
Nigeria a/	1,522
Other Africa	292
TOTAL	5,592
Asia-Pacific	
Indonesia a/	887
Other Asia-Pacific	711
TOTAL	1,598
Western Europe	355
WESTERN HEMISPHERE	
United States	9,544
Canada	1,358
Venezuela a/	3,547
Other Western Hemisphere	1,516
TOTAL	15,966
Total Non-Communist	39,896
Communist Area	8,315
USSR	7,440
Other	875
Total Other World	48,211

a/ *OPEC member.*

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MEMORANDUM FOR: Mr. Cline, Director INR

Formerly Staff Memo 5-72

The attached effort to explain and analyze important new developments affecting the international oil business has been distributed to the following in State:

Assistant Secretary Joseph J. Sisco
Deputy Assistant Secretary Rodger P. Davies
Deputy Assistant Secretary Alfred L. Atherton
Warren Clark, AF/N
Francois Dickman, ARP
Jack C. Miklos, Country Director, Iran
Talcott Seelye, Country Director, ARN
James Akins, Office of Fuels and Energy

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JOHN HUIZENGA
Director
National Estimates

24 March 72
(DATE)

FORM NO. 101 REPLACES FORM 10-101
1 AUG 54 WHICH MAY BE USED. (47)

MEMORANDUM FOR: Mr. Colby

This is a first attempt to get an analytical handle on a major new development affecting the international oil business.

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John Huizenga

24 March 72
(DATE)

FORM NO. 101 REPLACES FORM 10-101
1 AUG 54 WHICH MAY BE USED. (47)

MEMORANDUM FOR: DCI

We have tried in this piece to break new analytical ground with a view to keeping pace with the fast-breaking and potentially important developments in the international oil business. Fortunately [redacted] 25X1 has been with us the last two weeks; his help was important in sorting out the complexities. I am distributing the paper to the NSC Staff and at Assistant Secretary level and below in State and Defense.

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John Huizenga

ONE Memo dtd 24 Mar 72
"This Year's Oil Crisis: The Issue of Participation"

24 March 72
(DATE)

FORM NO. 101 REPLACES FORM 10-101 WHICH MAY BE USED.
1 AUG 54 (47)